



OFFICE OF  
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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This is in reply to your letter dated April 27, 2000 which we jointly determined with your accountant (under written authorization) was appropriate to answer as a request for general information. In general, you wish to be sure that a proposed method of withdrawing from an annuity contract will avoid the so-called "penalty tax" on early distributions. Because you are not yet 59-1/2, you intend to ask your insurance company to pay equal payments to you every year from now on. The intent is to take advantage of the exception from the penalty tax for "substantially equal payments." Your accountant and the insurance company will calculate the yearly payment using your life expectancy and an interest rate appropriate for use under the second method described in Notice 89-25, 1989-1 C.B. 203. A copy of Notice 89-25 is enclosed for their use.

The exceptions that allow an individual to avoid the penalty tax and the methods of calculating substantially equal periodic payments are described in Notice 89-25, the statute itself, and in Publication 590. This letter will describe those rules in general. However, I suggest that you, your accountant, and the insurance company look at Publication 590 for the necessary life expectancy tables and other details.

Section 72(e) of the Internal Revenue Code (the "Code") provides rules for determining how amounts received from annuity contracts, but not in the form of an annuity payment, are to be taxed. In general, for a contract purchased after 1982, each non-annuity distribution from an annuity contract will be treated first as a payment of the income accumulated in the contract. As a result, the entire distribution is included in gross income as ordinary income and no portion is treated as a return of investment in the contract until all of the income has been distributed. Only then will the amount received be treated as a non-taxable return of the investment in the contract.

If payments under an annuity contract are received before the taxpayer is 59-1/2, section 72(q)(1) imposes a "penalty tax" equal to ten percent of the taxable portion of the amount received. There are exceptions to the penalty tax, among them one for

distributions which are part of a series of substantially equal periodic payments (paid not less frequently than annually) made for the life (or life expectancy) of the annuitant or the joint lives (or life expectancies) of the annuitant and his or her beneficiary.

Once a stream of substantially equal withdrawals from an annuity contract is started, the payments must continue for the greater of 5 years from the date of the first payment or the taxpayer becoming 59-1/2. If the payments stop or are modified before that period ends -- other than because the recipient dies or becoming disabled -- all of the amounts previously excepted from the penalty become subject to the penalty (with interest), all the way back to the first payment. As a result, it is critical not only to calculate the withdrawal amount but properly also to make each withdrawal as originally planned.

Notice 89-25 nominally applies to qualified plans rather than non-qualified annuities purchased directly by individuals. Nonetheless, the methodology for determining substantially equal payments is useable for non-qualified contracts. The three methods described in the Notice are:

(1) The [annuity] balance is divided by the life expectancy to determine an amount that satisfies the minimum distribution rules that apply to qualified plans.

(2) The [annuity] account balance is amortized over the number of years equal to the life expectancy of the account owner with life expectancies determined in accordance with the rules that apply to qualified plans at an interest rate that does not exceed a reasonable interest rate on the date payments begin.

(3) Distributions are computed by dividing the account balance by an annuity factor determined using a reasonable mortality table and reasonable interest rate.

In general, for purposes of determining substantially equal periodic payments, a rate that does not exceed 120 percent of the Federal Mid-Term Rate is reasonable. Rev. Rul. 2000-38, 2000-32 I.R.B. 1 -- a copy of which is attached -- lists the rates for the month of August 2000. The annual Federal Mid-Term Rate itself is 6.33 percent. The ruling also states that 120 of the annual Federal Mid-Term Rate for August 2000 is 7.66 percent.

This letter provides general information only and is not a written determination with respect to the matters that you have presented or as to any other transaction. We hope that this information is helpful in addressing your concerns.

Sincerely,

Acting Associate Counsel  
Financial Institutions and Products

By:

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Mark S. Smith  
Chief, Branch 4

cc:



Enclosure:

Publication 590  
Rev. Rul 2000-38  
Notice 89-25